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How the Regulatory Effects of Distressed Loans Affect Lenders, Borrowers and Loan Purchasers

04.28.2009

Successful transactions often depend on structuring solutions that minimize negative regulatory impacts on the lender. Banks and other financial institutions are subject to extensive state and federal regulation. Given the current economic downturn, loans secured by real estate are subject to increased regulatory scrutiny. If the risk of nonpayment of a loan increases because of a borrower default, a decline in the value of the real estate collateral or other factors, the lender will face additional regulatory requirements. Therefore, all involved parties need to be aware of regulatory matters affecting the loan.

In many transactions, our clients have requested bank regulation expertise. The following are excerpts on this subject from a consultant we have worked with on bank regulatory matters.

How Loans are Classified. Every bank is required to assign an internal risk assessment to each of its loans and borrowers. These risk ratings are based on performance expectations during the life of the loan. The most favorable rating is "Pass," which generally means that the bank expects all principal and interest will be collected upon the agreed terms. The next level, "Special Mention," applies when there may be some stress in the relationship with the borrower, although without any anticipated loss of principal. A loan is rated "Substandard" when the bank determines it is not likely that all principal and interest will be collected in a reasonable time. This level is usually triggered by a borrower's payment history, or expected payment capacity, or the collateral value in the current marketplace. Lastly, the dubious designation of "Doubtful" describes a loan where loss of principal is expected and the bank must "charge-off" or write down its investment.

Regulatory Effects of the Loan Classification. The accounting pronouncement known as FASB 114 is a complex accounting rule that affects financial institutions. When a borrowing relationship slips into the "Substandard" classification, this accounting rule comes into play. FASB 114 requires a "mark to market" of a bad asset, meaning that the bank must value the loan based on the current market value of the collateral. A declining market, such as the current one, magnifies the effect of this rule. Given current conditions, lenders will often have to significantly decrease the value of loan assets. When this occurs, the regulatory and finance pressures on the bank may increase significantly, which may in turn raise tensions with the borrower. Although FASB recently announced new "mark to market" rules for certain assets where an active market does not exist, these rule generally will not apply to loans outside of the securitized mortgage-backed assets.

Lender Capital Reserve Requirements. In each designated level of risk assessment, the bank is required by FASB 114 to set aside part of its capital as "reserves." A loan in the "Pass" category will generally have a capital reserve requirement of 1% of the loan principal balance. As the risk rating of the loan increases, the capital requirements also increase and may be a high as 25%, or in extreme cases such as land loans, as much as 50% of the loan amount. When a loan is designated Substandard, this percentage allocation method generally increases the accounting for a loss exposure to the lender because it assumes that a "bulk-sale" liquidation of the collateral will occur. When the bank is required to set aside additional capital reserves, this capital is not available to fund new loans or finance bank operations.

Resolving Problems Can Preserve the Lending Relationship. By proactively addressing potential loan problems, the parties may avoid a caustic showdown. A loan modification is generally more beneficial for both parties than the path of default, foreclosure and bankruptcy.

To successfully structure a distressed real estate loan transaction, the parties should understand the regulatory issues confronting the lender, initiate a dialogue at the earliest point of stress and seek creative solutions that reduce loses and maximize value for all parties to the transaction.

Attorneys

David M. Hymer